**Fate of dollar depends on swift solution**

By Michael Mackenzie and Francesco Guerrera in New York

Any sign that the US government does not back Fannie Mae and Freddie Mac,pillars of the US mortgage market with debt widely held by foreign investors, could place the already weak dollar under further pressure.

The dollar slid last week as the euro rose to a threemonth high of $1.0544 to less than a cent below its record peak of $1.0618, set in April. Analysts blamed some of the dollar's fall on the drop in Fannie and Freddie's share prices amid further distress in the US financial sector.

Non-US investors hold close to a record $1.52bn ($268bn; €208bn) of debt issued by US government-sponsored enterprises (GSEs), according to data from the Federal Reserve.

Over the past decade, non-US investors, including central banks, have increasingly sought the higher yields offered on this so-called agency debt compared with Treasuries. In the past year, China has bought $6bn in agencies and only $1.5bn of Treasuries, while Russia bought $8bn to leverage its $22bn of Treasuries, according to Alan Ruskin, chief international strategist at RBS Greenwich.

They, like other investors, have long argued that the debt issued by the GSEs is implicitly backed by the US government, valuing it closer to leveraged Treasuries than higher-risk corporate debt.

Investors will likely want to see a clear and uniform response from policymakers, and any sign of delay or vacillation could spark further weakness in the dollar and the selling of agency debt.

"Some countries have made notable efforts to concentrate their buying in agencies," said Mr Ruskin. "The mix of large outstanding holdings and ongoing financing needs is one reason why a solution needs to be found fast, if the dollar is not to crack key levels, creating a wider problem."

The idea that policymakers would prompt a run on the dollar and US debt markets as they try to shore up the GSEs is unthinkable, analysts warn.

Ajay Rajadhyaksha, head of US fixed income strategy at Barclays Capital in New York, said: "I don't see any circumstance where the senior agency debt would default. A default would call into question the full faith and credit of the US government."

The next test for the agency debt market looming today, when Freddie Mac sells $3bn of short-term debt.

A nagging worry for investors is that there is still no clear consensus about whether the GSEs can count on US government support.

Mr Ruskin said: "Even if confidence is restored by making the government backing of this paper more explicit, it is bound to lead to leveraged Treasuries and the scramble for agency yield in a low yielding, high risk and weak dollar universe."

Additional reporting by Nicole Bullock

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**Q & A**

What are Fannie Mae and Freddie Mac?

They are publicly traded companies based in the US that were created by the government in 1938 and 1968 respectively to provide liquidity to the mortgage market and bolster home ownership. Their size has ballooned to the point where they now own or guarantee almost half of the $12,000bn US mortgage market.

As the housing crisis has deepened and lenders have pulled back, Fannie Mae and Freddie Mac have accounted for an even greater 70 per cent chunk of new mortgages.

Why are they experiencing such turmoil?

Fannie Mae and Freddie Mac make their money by charging a fee to guarantee mortgages that they purchase and package as mortgage-backed securities. As home prices have fallen and foreclosures have risen across the country, they have incurred huge losses, which they have tried to tackle by raising capital.

What would happen if Fannie Mae and Freddie Mac went bankrupt?

If the two companies collapsed, the consequences could be disastrous for the global financial system. The US mortgage market would be likely to grind to a halt, prolonging the housing crisis and probably delaying any chances of an economic recovery. Even worse, investors around the world are holders of Fannie Mae and Freddie Mac debt, which has been considered one of the safest securities available. A sharp sell-off of these instruments would further deepen the global credit crisis.

Isn't the government supposed to stand behind Fannie Mae and Freddie Mac?

The US government has never explicitly said it would guarantee the two companies' obligations. However, because of their importance to the financial system, many investors have assumed they are "too big to fail." That confidence is being put to the test, although the debate is less about whether the US will step in to rescue Fannie Mae and Freddie Mac and more about how they will do so.

What options are open to policymakers such as Hank Paulson, Treasury secretary, and Ben Bernanke, Fed chairman?

The most dramatic would be for the government to invoke "conservatorship" powers, in effect taking over Fannie Mae and Freddie Mac by wiping out common shareholders but protecting debt-holders and allowing the companies to keep providing liquidity to the US mortgage markets. However, other intermediate steps could also be taken, including lowering the capital requirements of the two companies, which would delay any technical insolvency, or allowing them to access emergency lending facilities such as the Fed's discount window. On Friday Mr Paulson sought to dismiss any talk of nationalising them by saying the Treasury was working to support the two companies in their "current form" — or owned by public shareholders. Nevertheless, talks about their future continued at the weekend.

Compiled by James Politi